

**SUBURBAN MOBILITY AUTHORITY
FOR REGIONAL TRANSPORTATION**

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December 15, 2005

Matthew Wirgau, Board Chairman
And Board Members of the Suburban
Mobility Authority for Regional Transportation
And Residents of Wayne, Oakland and Macomb Counties, Michigan:

It is a pleasure to submit to you the annual financial statement of the Suburban Mobility Authority for Regional Transportation ("SMART or "Authority") for the year ended June 30, 2005.

SMART's independent audit was conducted by KPMG LLP who has issued an unqualified audit report on these financial statements.

This report contains Independent Auditors' Report, Management's Discussion and Analysis, the Basic Financial Statements, Statement of Cash Flow and Notes to the Financial Statement.

As stated in the Auditors' Report, the financial statements referred to above, present fairly, in all material respects, the financial position of SMART as of June 30, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

CURRENT YEAR REVIEW

Ridership

Ridership on all SMART services continued to grow from 2004 to 2005, a 9% increase with over 800,000 riders added. Looking forward, in October 2005, SMART ridership exceeded one million for the month, the highest ridership count in over 25 years.



Also serving Monroe County



State Funding

The Table below includes total Act 51 revenue received by SMART and the percentage of the state funded portion of the eligible costs for the current year and seven prior years. The Act 51 revenue includes urban, non-urban, municipal credits, and adjustments.

	<u>Act 51 Revenue</u>	<u>State's % of eligible costs</u>
Fiscal year ended June 30:		
1998	\$ 36,342,399	50.00%
1999	36,210,856	43.00%
2000	33,948,040	39.76%
2001	33,539,932	37.06%
2002	33,692,498	38.08%
2003	34,496,055	35.60%
2004	35,041,975	35.20%
2005	32,968,235	32.43%

The Federal preventative maintenance grant has historically been "matched" with State funding (80% Federal/20% State). Starting in FY2005, the State is matching Federal grants with toll credits, which do not pass through to the Authority. This resulted in \$2.7 million less in State funding, which is not included in the above table for Act 51 formula based revenue.

Service

Due to the high volume of passengers, SMART is experiencing "standing room only" on a number of trips. SMART continually reviews the performance of its fixed route service to reduce or eliminate inefficient service and increase trips on those routes that demand more service. Actually the number of customers using SMART service increased by 9.6 percent yet the number of route miles has actually decreased by 0.4 percent annually. In essence SMART is carrying more riders with fewer miles operated.

Community Transit Program

The number of buses operated through SMART's community based program continues to increase as does ridership. A total of 183 buses are operating in this program in opt-in communities and 29 in opt-out communities with over 660,000 riders carried during FY 2005.

Bikes on Board

Almost 40,000 passengers brought their bikes along for the ride in 2005. All linehaul coaches are equipped with bike racks which link passengers to jobs and school.

Gas Prices

In 2005, gas prices skyrocketed. While ridership was showing impressive increases before the spike in gas prices, the number of customers choosing SMART bus service grew even further as fuel costs increased. Many of the people using transit were first time users of the system.

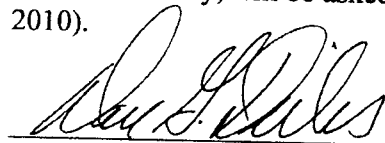
Health Care Committee

With joint effort between union representatives and management, SMART will save approximately \$1.6 million annually in health care costs. It was mutually agreed that due to the great success achieved the health care committee continues to meet to identify other potential fringe benefit savings.

FUTURE

In November, 2005, Livonia voters approved a ballot question that authorizes the City Council to withdraw from the Wayne County 196 Committee and set up their own service. It is expected that the Livonia City Council will withdraw from the Wayne County Transit Authority by February 1, 2006. Thus SMART service for Livonia residents will cease in September, 2006. The \$2.8 million in lost millage revenues from Livonia, will be offset by service reductions, to balance the FY2007 budget.

On August 6, 2006, voters in portions of Wayne and Oakland counties and all of Macomb County, will be asked to renew the .6 mill property tax for four years (2007-2010).



Dan G. Dirks,
General Manager



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Independent Auditors' Report

The Board of Directors
Suburban Mobility Authority
for Regional Transportation:

We have audited the accompanying basic financial statements of Suburban Mobility Authority for Regional Transportation (SMART) as of and for the years ended June 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of SMART's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of SMART's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SMART as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 11, 2005 on our consideration of SMART's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

The Management's Discussion and Analysis and the schedule of funding progress are not a required part of the basic financial statements, but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.



Our audits were made for the purposes of forming an opinion on the basic financial statements taken as a whole. The Transmittal Letter is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied by us in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

KPMG LLP

November 11, 2005

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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

Overview of the Financial Statements and Financial Analysis

The following discussion and analysis has been prepared by SMART's management and should be read in conjunction with the financial statements and related footnote disclosures by which it is qualified in its entirety. The discussion is intended to present an overview of SMART's financial performance for the years ended June 30, 2005 and 2004 and does not purport to make any statement regarding the future operations of the organization. While SMART is an instrumentality of the State of Michigan, it is not a component of the State as defined by the Governmental Accounting Standards Board (GASB).

The annual report consists of the statement of net assets, statement of revenues, expenses, and changes in net assets, and the statement of cash flows, prepared in accordance with GASB principles.

Financial Highlights – FY 2005

SMART's current assets increased by \$0.8 million due primarily to a surplus of revenue over expense for the year (excluding depreciation on assets purchased with capital grants).

Noncurrent assets decreased from the prior year by \$8.8 million due primarily to depreciation charges on buses and other equipment (\$14.0 million) offset by the addition of \$5.6 million in vehicles and related equipment.

Total liabilities decreased by \$5.6 million due to the annual payments against the debt incurred for the purchase of 287 linehaul buses in FY 2001, 2002, and 2003.

Net assets decreased from \$57.2 million at June 30, 2004 to \$55.2 million at June 30, 2005.

Operating revenues increased by \$0.6 million as the result of an increase in linehaul ridership of approximately 6%.

Total operating expenses before depreciation expense increased by \$5.1 million as the result of inflation of approximately 5.4%. This includes an increase in diesel fuel cost of \$1.6 million or 42%.

Financial Highlights – FY 2004

SMART's current assets increased by \$7.6 million due primarily to a surplus of revenue over expense for the year (excluding depreciation on assets purchased with capital grants).

Noncurrent assets decreased from the prior year by \$14.3 million due primarily to depreciation charges on buses and other equipment (\$18.4 million) offset by the addition of \$4.4 million in vehicles and related equipment.

Total liabilities decreased by \$5.9 million due to the annual payments against the debt incurred for the purchase of 287 linehaul buses in FY 2001, 2002, and 2003.

Net assets decreased from \$57.4 million at June 30, 2003 to \$57.2 million at June 30, 2004.

Operating revenues increased by \$0.4 million as the result of an increase in linehaul ridership of approximately 4%.

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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

Total operating expenses before depreciation expense increased by \$2.6 million as a result of inflation of approximately 3.8%.

Statement of Net Assets

The statement of net assets includes all assets and liabilities. It is prepared using the accrual basis of accounting, whereby revenues and assets are recognized when the service is provided and expenses and liabilities are recognized when others provide the service, regardless of when cash is exchanged. Assets and liabilities are generally measured using current values. One exception is capital assets, which are stated at historical cost less an allowance for depreciation.

A summarization of SMART's assets, liabilities, and net assets at June 30, 2005, 2004, and 2003 follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Assets:			
Current assets	\$ 47.3	46.5	38.9
Noncurrent assets	93.3	101.6	115.9
Total assets	<u>\$ 140.6</u>	<u>148.1</u>	<u>154.8</u>
Liabilities:			
Current liabilities	\$ 40.6	38.2	36.8
Noncurrent liabilities	44.8	52.7	60.6
Total liabilities	<u>\$ 85.4</u>	<u>90.9</u>	<u>97.4</u>
Net assets:			
Invested in capital assets, net of related debt	\$ 40.6	41.4	48.8
Unrestricted	14.6	15.8	8.6
Total net assets	<u>\$ 55.2</u>	<u>57.2</u>	<u>57.4</u>

At June 30, 2005, total SMART assets were \$140.6 million, compared to \$148.1 million in fiscal year 2004 and \$154.8 million in fiscal year 2003. SMART's largest asset is its investment in linehaul and community transit buses and related equipment, at \$67.9 million, compared to \$74.2 million in 2004 and \$66.6 million in 2003. The balance of SMART's capital assets consists primarily of buildings and other equipment. Grants receivable decreased from \$19.9 million in FY 2004 to \$13.3 million in FY 2005 due to the timing of grant collections related to the transportation funding reauthorization efforts of the U.S. Congress. \$12.9 million of the \$19.9 million in grants receivable was collected in the first four months of FY 2005 and \$10.8 million of the \$13.3 million in grants receivable was collected in the first three months of FY 2006. The materials and supplies inventory decreased from \$2.5 million in FY 2004 to \$2.0 million in FY 2005 as the result of the sale of obsolete parts for retired buses.

SMART's liabilities total \$85.4 million at June 30, 2005, compared to \$90.9 million in 2004 and \$97.4 million in 2003. Long-term debt of \$44.8 million consists of payments due under a lease/purchase agreement with Gillig Corp. for 287 linehaul buses. Accrued self-insurance increased from \$12.1 million to \$14.6 million as the result

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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

of the timing involved in settling claims. Self-insurance expense for FY 2005 increased by \$1.8, and decreased by \$1.8 million in FY2004.

Statement of Revenues, Expenses, and Changes in Net Assets

The statement of revenues, expenses, and changes in net assets presents the operating results of SMART, as well as the nonoperating revenues and expenses. Operating revenues consist primarily of fare box revenue from linehaul and community transit services. Advertising and other revenues are also included in this category.

SMART is also dependent on state, federal, and local operating assistance, as well as income from investment activities, which are prescribed by GASB as nonoperating revenues. Operating expenses, as well as capital contributions, need to be included.

A summary of SMART's revenues, expenses, and changes in net assets for the years ended June 30, 2005, 2004, and 2003 is as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating revenue	\$ 9.8	9.2	8.8
Operating expenses before depreciation	99.1	94.1	91.2
Operating loss before depreciation	(89.3)	(84.9)	(82.4)
Depreciation expense	14.0	16.0	13.7
Total operating loss	(103.3)	(100.9)	(96.1)
Nonoperating revenues, net	95.9	96.6	94.2
Net loss before capital contributions	(7.4)	(4.3)	(1.9)
Capital contributions	5.4	4.1	7.3
Net gain (loss)	(2.0)	(0.2)	5.4
Net assets, beginning of the year	57.2	57.4	52.0
Net assets, end of the year	\$ 55.2	57.2	57.4

SMART's primary sources of revenue are federal, state, and local operating assistance, which are classified as nonoperating revenue. As the result of declining state operating assistance, SMART placed a ballot question before the electorate in August 2002 to increase the local property tax millage from 1/3 mill to 6/10 mill for the years 2003 to 2006. The increased millage was approved by participating communities in Wayne, Oakland, and Macomb counties.

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Management's Discussion and Analysis

June 30, 2005 and 2004

(Unaudited)

Diesel fuel increased by \$1.6 million due primarily to a 42% increase in diesel fuel cost per gallon. Vehicle liability reserve increased expense by \$1.8 million based upon the actuarial report of required loss and loss adjustment expense reserves. This includes case basis reserves and a mean estimate for IBNR (incurred but not reported). Depreciation expense decreased by \$2.0 million due to the September 2004 sale of age or mileage eligible linehaul buses.

Capital contributions consist primarily of federal and state grants for the purchase of replacement and new capital assets. Most of the funds are provided through a federal formula administered by the Federal Transportation Administration. Discretionary funds are also made available in most years. At SMART's discretion, a portion of the federal formula dollars can be used as an offset to preventive maintenance expense.

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Balance Sheets
June 30, 2005 and 2004

Assets	2005	2004
Current assets:		
Cash and cash equivalents	\$ 26,881,866	18,576,490
Operating assistance due from State of Michigan	476,791	797,690
Accrued interest receivable	4,931	20,695
Grants receivable	13,343,070	19,889,584
Local contributions receivable	3,227,664	3,333,992
Other receivables	452,384	531,073
Materials and supplies inventory	1,981,307	2,474,756
Prepaid expenses	956,945	889,805
Total current assets	47,324,958	46,514,085
Net pension asset	402,220	—
Capital assets, net	92,842,626	101,596,528
Total assets	\$ 140,569,804	148,110,613
Liabilities and Net Assets		
Current liabilities:		
Municipal and community credits payable	\$ 6,448,766	6,277,929
Amounts payable under purchase-of-service agreements	202,264	380,995
Accrued self-insurance	14,569,339	12,108,189
Payable to State of Michigan	953,855	9,248
Accounts payable and accrued expenses	5,217,958	5,733,590
Accrued interest payable	1,027,310	1,154,857
Current portion of notes payable	7,871,654	7,522,161
Accrued compensation	4,314,851	5,048,620
Total current liabilities	40,605,997	38,235,589
Net pension obligation	—	49,229
Notes payable, net of current portion	44,783,139	52,654,793
Total liabilities	85,389,136	90,939,611
Net assets:		
Invested in capital assets, net of related debt	40,590,055	41,419,574
Unrestricted	14,590,613	15,751,428
Total net assets	55,180,668	57,171,002
Total liabilities and net assets	\$ 140,569,804	148,110,613

See accompanying notes to financial statements.

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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues:		
Revenues from transit operation	\$ 9,811,309	9,233,136
Operating expenses before depreciation expense:		
Salaries and wages	41,606,341	40,452,460
Fringe benefits	21,308,015	21,451,535
Contractual services	6,216,063	6,457,265
Materials and supplies	11,536,752	9,230,564
Utilities	2,304,375	2,490,117
Claims and insurance	6,735,388	4,659,142
Purchased transportation	9,084,284	8,862,811
Miscellaneous expenses	393,757	500,826
Total operating expenses before depreciation expense	99,184,975	94,104,720
Depreciation expense	13,955,198	15,985,992
Total operating expenses	113,140,173	110,090,712
Total operating loss	(103,328,864)	(100,857,576)
Nonoperating revenues (expenses):		
Federal operating and preventive maintenance assistance	14,918,611	15,250,612
State operating grants	34,316,023	39,227,799
Local contributions	49,354,424	47,625,635
Interest income	574,757	301,581
Interest expense	(2,871,031)	(3,465,243)
Loss on retirement of assets	(359,949)	(2,400,990)
Other income	866	726
Total nonoperating revenues, net	95,933,701	96,540,120
Change in net assets before capital contributions	(7,395,163)	(4,317,456)
Capital contributions	5,404,829	4,089,988
Change in net assets	(1,990,334)	(227,468)
Net assets, beginning of the year	57,171,002	57,398,470
Net assets, end of the year	\$ 55,180,668	57,171,002

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Receipts from transit operations	\$ 9,889,825	9,317,593
Payments for salaries and wages and fringe benefits	(64,099,574)	(61,959,363)
Payments to suppliers	(19,424,653)	(18,520,312)
Payments for claims and insurance	(4,274,238)	(3,256,593)
Payments for purchased transportation	(9,263,015)	(8,705,359)
Net cash used in operating activities	<u>(87,171,655)</u>	<u>(83,124,034)</u>
Cash flows from noncapital and related financing activities:		
Federal operating and preventive maintenance assistance	20,214,262	2,895,812
State operating grants	34,636,922	39,586,436
Local contributions	49,460,752	47,273,658
Other revenues	866	726
Net cash provided by noncapital and related financing activities	<u>104,312,802</u>	<u>89,756,632</u>
Cash flows from capital and related financing activities:		
Capital grants received	6,655,693	5,681,869
Purchase of capital assets	(5,585,399)	(4,080,369)
Proceeds from disposals of capital assets	24,153	—
Proceeds from installment note	—	144,239
Payment on installment note payable	(7,522,161)	(7,080,483)
Interest paid	(2,998,578)	(3,657,251)
Net cash used in capital and related financing activities	<u>(9,426,292)</u>	<u>(8,991,995)</u>
Cash flows from investing activities:		
Interest received	590,521	342,250
Net cash provided by investing activities	<u>590,521</u>	<u>342,250</u>
Net increase (decrease) in cash and cash equivalents	8,305,376	(2,017,147)
Cash and cash equivalents, beginning of year	18,576,490	20,593,637
Cash and cash equivalents, end of year	\$ <u>26,881,866</u>	<u>18,576,490</u>
Noncash activities:		
Loss on retirement of assets	\$ 359,949	2,400,990

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Statements of Cash Flows

Years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (103,328,864)	(100,857,576)
Adjustments to reconcile to net cash used in operating activities:		
Depreciation expense	13,955,198	15,985,992
Change in assets and liabilities:		
Decrease in other receivables	78,689	258,307
Decrease in materials and supplies	493,449	901,095
Increase in prepaid expenses	(67,140)	(91,496)
Increase in municipal and community credits payable	170,837	396,125
Increase (decrease) in amounts payable under purchase-of-service agreements	(178,731)	157,452
Increase in accrued self-insurance	2,461,150	1,402,549
Increase (decrease) in payable to the State of Michigan	944,607	(76,331)
Decrease in accounts payable and accrued expenses	(515,632)	(1,144,783)
Decrease in net pension obligation	(451,449)	(551,056)
Increase (decrease) in accrued compensation	(733,769)	495,688
Net cash used in operating activities	<u>\$ (87,171,655)</u>	<u>(83,124,034)</u>

See accompanying notes to financial statements.

SUBURBAN MOBILITY AUTHORITY FOR REGIONAL TRANSPORTATION

Notes to Financial Statements

June 30, 2005 and 2004

(1) Description of Operations and the Entity

(a) Organization

Suburban Mobility Authority for Regional Transportation (SMART or the Authority), an instrumentality of the State of Michigan, is a public benefit agency created pursuant to the provisions of Act No. 204 of the Public Acts of Michigan of 1967, as amended. SMART is charged with the responsibility to plan, acquire, construct, operate, maintain, replace, improve, extend, and contract for public transportation facilities within the counties of Macomb, Oakland, and Wayne. SMART is managed by a seven-member board of directors, who represent the counties that comprise SMART's operating region.

In August 2002, voters in Macomb County and in those communities participating in Act 196 Transportation Authorities in Oakland County and Wayne County approved a four-year, 6/10-mill property tax dedicated to public transportation. Tax revenues received by Macomb County, the Wayne County Act 196 Authority, and the Oakland County Act 196 Authority and contributed to SMART for the years ended June 30, 2005 and 2004 were \$49,354,423 and \$47,625,635, respectively.

Pursuant to the provisions of legislation enacted in 1988 which amended Act No. 204, a corporation known as the Regional Transit Coordinating Council (RTCC) is the designated recipient of operating assistance funds from the State of Michigan and the Federal Transit Administration (FTA). SMART and the Detroit Department of Transportation (DDOT) are subrecipients of such operating assistance funds. The Articles of Incorporation of RTCC provide that 35% of any state or federal transportation operating assistance or formula capital grants or loans is to be distributed to SMART, and the remaining 65% is to be distributed to DDOT. FTA and the State of Michigan pay such funds directly to SMART and DDOT at the direction of RTCC. Capital grants or loans – which are not allocated on a formula basis by the responsible federal or state agencies but, rather, are allocated on a specific project or asset basis – are allocated to SMART and DDOT based on the terms of the grant or loan.

(b) Reporting Entity

For financial reporting purposes, all departments and operations over which SMART exercises oversight responsibility are included in the reporting entity. Oversight responsibility was evaluated based on consideration of financial interdependency, selection of governing authority, designation of management, the ability to significantly influence management, and accountability for fiscal matters.

No governmental units other than SMART itself are included in the reporting entity. SMART does not have oversight responsibility over any other governmental unit. This is evidenced by the fact that, with respect to any other governmental unit, including the transportation agencies with which SMART has entered into purchase-of-service agreements (see note 7), or the Act 196 Transportation Authorities in the counties served by SMART, SMART does not select their governing authority, designate their management, exercise significant influence over their daily operations, or maintain their accounting records.

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June 30, 2005 and 2004

SMART is not included within the reporting entity of the State of Michigan, because the State has no authority to appoint or remove SMART's management or board of directors and is not accountable for its fiscal matters.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

The accounting policies of the Authority conform to accounting principles generally accepted in the United States of America (GAAP) as applicable to governmental entities. The accounts of the Authority, which are organized as an Enterprise fund, are used to account for the Authority's activities that are financed and operated in a manner similar to a private business enterprise. Accordingly, the Authority maintains its records on the accrual basis of accounting using the economic resources measurement focus. Revenues from operations, investments, and other sources are recorded when earned. Expenses (including depreciation and amortization) of providing services to the public are accrued when incurred.

Nonexchange transactions, in which SMART receives value without directly giving equal value in return, include federal operating and preventative maintenance assistance, state operating grants, local contributions from property taxes, and capital contributions. On an accrual basis, revenue from these grants and contributions is recognized in the fiscal year in which all eligibility requirements have been satisfied. Eligibility requirements include timing requirements, which specify the year when the resources are required to be used or the fiscal year when use is first permitted, and expenditure requirements, in which the resources are provided to SMART on a reimbursement basis.

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Authority applies all applicable GASB pronouncements, as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

(b) Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date of acquisition.

(c) Materials and Supplies

Materials and supplies consist of repair parts for buses and operating supplies and are valued at the lower of cost or market, with cost determined on an average-cost basis.

(d) Capital Assets

Capital assets are defined by the Authority as assets with an initial individual cost of more than \$2,500 (\$1,000 for computer equipment) and an estimated useful life in excess of a year. Purchased or constructed capital assets are reported at cost or estimated historical cost. Improvements, which

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Notes to Financial Statements

June 30, 2005 and 2004

extend the useful lives of the assets, are capitalized. Donated fixed assets are recorded at their estimated fair value at the date of donation. The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized.

Depreciation is computed using the straight-line method, based upon the estimated useful lives of the assets as follows:

Buildings	25 years
Linehaul buses	7 – 12 years
Community transit buses	4 – 7 years
Equipment and office furniture	3 – 10 years

Leasehold improvements are amortized over the shorter of the life of the improvement or the life of the related lease.

(e) *Claims Expense*

Claims expense is accrued in the period that incidents of loss occur, based upon estimates of liability made by management with the assistance of third-party administrators, legal counsel, and actuaries. Claims liability represents management's best estimate based on known information.

(f) *Compensated Absences*

SMART employees earn vacation and sick leave, which is generally fully vested when earned. Unused vacation time may be carried over to the following year with certain limitations; upon termination of employment, employees are paid for unused accumulated vacation. With certain limitations, sick leave may be accumulated and paid upon retirement and, for certain employees, upon voluntary termination of employment. For certain employees, some accumulated sick leave may also be converted into additional vacation time. Accumulated unpaid vacation and sick leave are recorded as a liability.

(g) *Capital Acquisition Grant Activities*

Federal and state capital acquisition grants fund the purchase of capital items, including buses, bus terminals, and related transportation equipment used by SMART and other transit agencies within the southeastern Michigan region. Capital grants for the acquisition of capital assets are recorded as grants receivable in the statement of net assets and capital contributions in the statement of revenues, expenses, and changes in net assets when the related qualified expenditures are incurred. When capital assets relating to other transit agencies are transferred to such transit agencies, their related costs are removed from the records of SMART.

When assets acquired with capital grant funds are disposed of, the Authority is required to notify the granting federal agency. A proportional amount of the proceeds or fair market value, if any, of such property may be used to acquire like-kind replacement vehicles or remitted to the granting federal agency.

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(h) Net Assets

Equity is displayed in three components as follows:

- *Invested in capital, net of related debt* – This consists of capital assets, net of accumulated depreciation, less the outstanding balances of any bonds, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- *Restricted* – This consists of net assets that are legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the Authority's policy to use restricted resources first and then unrestricted resources when they are needed. The Authority does not have restricted net assets at June 30, 2005 or 2004.
- *Unrestricted* – This consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

(i) Classification of Revenues

SMART has classified its revenues as either operating or nonoperating revenues according to the following criteria:

- *Operating revenues* – Operating revenues include activities that have the characteristics of exchange transactions, such as revenues from transit operations.
- *Nonoperating revenues* – Nonoperating revenues include activities that have the characteristics of nonexchange transactions that are defined as nonoperating revenues by GASB No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, and GASB No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, such as federal and state contributions and investment income.

(j) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(k) Reclassifications

Certain amounts from the prior year have been reclassified to conform to the current year presentation.

(l) New Accounting Pronouncements

The Governmental Accounting Standards Board (GASB) issued four new accounting pronouncements. Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital*

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Assets and for Insurance Recoveries; Statement No. 46, *Net Assets Restricted by Enabling Legislation – an Amendment of GASB Statement No. 34*; and Statement No. 47, *Accounting for Termination Benefits*, are effective for the fiscal year beginning July 1, 2005. Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, is effective for the fiscal year beginning July 1, 2007. SMART has not yet determined the effect, if any, the pronouncements will have on its financial statements.

SMART adopted GASB Statement No. 40, *Deposit and Investment Risk Disclosures – an Amendment of GASB Statement No. 3*, for the year ended June 30, 2005. This pronouncement requires additional disclosures presented in these notes, but has no impact on the net assets. These disclosures address common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. Data related to the above disclosures for the year ended June 30, 2004 were unavailable.

(3) State of Michigan Operating Assistance Funds

Under Act 51 of the Public Acts of 1951, as amended, the State of Michigan makes distributions of funds that have been appropriated for mass transit operating assistance. RTCC is the designated recipient of such funds, and SMART is a subrecipient of RTCC. SMART has recorded operating grant revenues under Act 51 based on a formula that takes into account the eligible costs incurred by SMART, estimates of eligible costs incurred by DDOT, locally generated revenues of SMART and DDOT, the percentage of RTCC's funding that is allocable to SMART, and preliminary information made available by the Michigan Department of Transportation (MDOT) as to the amount of funds expected to be available to the RTCC.

Based on the latest available determinations of State operating assistance allocable to SMART in accordance with the Act 51 funding formula, for certain of the State's fiscal years through September 30, 2003, operating assistance payments were received in excess of the amounts allocable to SMART. The overpayments, in the amount of \$953,855 and \$9,248, are recorded as a payable to the State of Michigan at June 30, 2005 and 2004, respectively.

Act 51 requires SMART to provide a portion of the State operating assistance as funding to municipalities within its transportation district. Amounts not used by the municipalities within two years must be expended by SMART for operating purposes within the county in which the city, village, or township lies. SMART was required to provide approximately \$3,059,000 pursuant to this provision in both fiscal years 2005 and 2004.

(4) Cash and Cash Equivalents

SMART has deposits with various financial institutions. At June 30, 2005 and 2004, the carrying amount of SMART's deposits was \$28,461,470 and \$18,576,490, respectively, and the bank balance was \$29,265,383 and \$18,945,533, respectively. The difference in carrying amount and the bank balance is due to items in transit and outstanding checks. Of the bank balances, \$300,000 was covered by federal depository insurance and the remainder was uncollateralized. Michigan law does not require collateralization of government deposits.

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SMART's deposits are primarily invested in a money market account with a major bank. SMART manages its funds in accordance with an investment policy adopted by the Board. The policy outlines the types of investments that may be entered into but does not limit the value of how much of the portfolio may be held by an outside party.

The investment policy adopted by SMART allows deposits and investments that are in accordance with State regulations. Michigan Compiled Laws Section 129.91 (Public Act 20 of 1943, as amended), authorizes SMART to make deposits and investments as follows. SMART is authorized to invest in the accounts of federally insured banks, credit unions, and savings and loan associations that have offices in Michigan. SMART is allowed to invest in bonds, securities, and other obligations of the United States or an agency or instrumentality of the United States; repurchase agreements; bankers' acceptances of United States banks; commercial paper rated with the two highest classifications, which matures not more than 270 days after the date of purchase; obligations of the State of Michigan or its political subdivisions, which are rated as investment grade; and mutual funds composed of investment vehicles that are legal for direct investment by local units of government in Michigan.

(5) Grants Receivable

At June 30, grants receivable are comprised of the following:

	<u>2005</u>	<u>2004</u>
Accounts receivable, billed:		
Federal Operating Grant (CMAQ)	\$ 1,039,859	1,223,244
Federal government grants	10,461,391	12,880,465
State of Michigan grants	971,875	3,476,826
Total billed	<u>12,473,125</u>	<u>17,580,535</u>
Accounts receivable, unbilled:		
Federal government grants	611,231	357,049
State of Michigan grants	141,042	1,871,004
Local grants	117,672	80,996
Total unbilled	<u>869,945</u>	<u>2,309,049</u>
Total	<u>\$ 13,343,070</u>	<u>19,889,584</u>

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(6) Capital Assets

Capital asset activity during the fiscal year ended June 30, 2005 is as follows:

	<u>Balance July 1, 2004</u>	<u>Additions</u>	<u>Deletions</u>	<u>Balance June 30, 2005</u>
Capital assets not being depreciated:				
Land	\$ 4,246,270			4,246,270
Construction in progress	256,607	162,053	256,607	162,053
Total capital assets not being depreciated	<u>4,502,877</u>	<u>162,053</u>	<u>256,607</u>	<u>4,408,323</u>
Capital assets being depreciated:				
Linehaul buses and equipment	91,364,704	109,536	749,568	90,724,672
Community transit buses and related equipment	25,447,068	3,744,928	746,852	28,445,144
Buildings	38,280,320	611,375	—	38,891,695
Office furniture and equipment	1,803,844	—	—	1,803,844
Other equipment	36,660,691	949,831	—	37,610,522
Leasehold improvements	3,282,157	264,283	—	3,546,440
Total capital assets being depreciated	<u>196,838,784</u>	<u>5,679,953</u>	<u>1,496,420</u>	<u>201,022,317</u>
Less accumulated depreciation and amortization:				
Linehaul buses and equipment	24,286,478	7,057,418	374,660	30,969,236
Community transit buses and related equipment	18,348,451	2,635,921	737,656	20,246,716
Buildings	25,035,105	1,114,272	—	26,149,377
Office furniture and equipment	1,686,723	23,537	—	1,710,260
Other equipment	28,411,885	2,933,921	—	31,345,806
Leasehold improvements	1,976,491	190,128	—	2,166,619
Total accumulated depreciation	<u>99,745,133</u>	<u>13,955,197</u>	<u>1,112,316</u>	<u>112,588,014</u>
Total capital assets being depreciated, net	<u>97,093,651</u>	<u>(8,275,244)</u>	<u>384,104</u>	<u>88,434,303</u>
Total capital assets, net	<u>\$ 101,596,528</u>	<u>(8,113,191)</u>	<u>640,711</u>	<u>92,842,626</u>

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Capital asset activity during the fiscal year ended June 30, 2004 is as follows:

	<u>Balance July 1, 2003</u>	<u>Additions</u>	<u>Deletions</u>	<u>Balance June 30, 2004</u>
Capital assets not being depreciated:				
Land	\$ 4,246,270	—	—	4,246,270
Construction in progress	21,018,217	256,607	21,018,217	256,607
Total capital assets not being depreciated	<u>25,264,487</u>	<u>256,607</u>	<u>21,018,217</u>	<u>4,502,877</u>
Capital assets being depreciated:				
Linehaul buses and equipment	83,481,499	20,413,374	12,530,169	91,364,704
Community transit buses and related equipment	25,162,119	560,664	275,715	25,447,068
Buildings	35,870,096	2,410,224	—	38,280,320
Office furniture and equipment	1,801,873	1,971	—	1,803,844
Other equipment	35,643,231	1,017,460	—	36,660,691
Leasehold improvements	2,809,068	473,089	—	3,282,157
Total capital assets being depreciated	<u>184,767,886</u>	<u>24,876,782</u>	<u>12,805,884</u>	<u>196,838,784</u>
Less accumulated depreciation and amortization:				
Linehaul buses and equipment	26,307,771	8,081,290	10,102,583	24,286,478
Community transit buses and related equipment	15,735,551	2,880,408	267,508	18,348,451
Buildings	23,900,782	1,134,323	—	25,035,105
Office furniture and equipment	1,662,713	24,010	—	1,686,723
Other equipment	24,703,449	3,708,436	—	28,411,885
Leasehold improvements	1,818,966	157,525	—	1,976,491
Total accumulated depreciation	<u>94,129,232</u>	<u>15,985,992</u>	<u>10,370,091</u>	<u>99,745,133</u>
Total capital assets being depreciated, net	<u>90,638,654</u>	<u>8,890,790</u>	<u>2,435,793</u>	<u>97,093,651</u>
Total capital assets, net	<u>\$ 115,903,141</u>	<u>9,147,397</u>	<u>23,454,010</u>	<u>101,596,528</u>

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(7) Purchase-of-Service Agreements

SMART has entered into purchase-of-service agreements with various transportation agencies, including community transit operators, all of which are separate transit systems operating in SMART's region. The agreements generally require that operating losses (as defined in the respective agreements) of these transportation agencies be subsidized up to specified maximum amounts.

Expenses under the purchase-of-service agreements for the years ended June 30 are comprised of the following:

	<u>2005</u>	<u>2004</u>
Municipal credits	\$ 3,058,956	3,058,956
Community credits	2,945,747	2,945,747
Community transit bus service	2,055,538	1,859,915
Specialized services	682,141	710,486
Ridesharing	—	103,271
NOTA	218,276	49,473
New services	49,626	44,150
Community-based services	74,000	90,813
Total	<u>\$ 9,084,284</u>	<u>8,862,811</u>

(8) Self-Insured Liabilities

In fiscal 2005 and 2004, SMART was a qualifying self-insurer for vehicle and general liability with a self retention per occurrence of \$1 million, and \$1 million aggregate corridor, and excess insurance in an amount of \$4 million per occurrence. SMART also was self-insured for workers' compensation claims up to \$500,000 per specific claim, and is insured up to \$5 million for aggregate losses in excess of \$500,000 per claim. Vehicle and general liability and workers' compensation claim liabilities are actuarially determined based on known information. Liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. These liabilities are classified as current, although some portion may not be paid within one year. Management believes, based on prior experience, that the estimated reserve for claims is adequate to satisfy all claims filed, or to be filed, for incidents that occurred through June 30, 2005.

Settled claims have not exceeded commercial coverage in any of the preceding three years.

SMART carries commercial insurance for other areas of risk, including health benefits.

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Changes in the balances of self-insured liabilities during fiscal 2005 and 2004 were as follows:

	<u>2005</u>	<u>2004</u>
Claims liability – July 1	\$ 12,108,189	10,705,640
Current year claims	6,163,098	4,674,603
Claim payments	<u>(3,701,948)</u>	<u>(3,272,054)</u>
Claims liability – June 30	<u>\$ 14,569,339</u>	<u>12,108,189</u>

(9) Notes Payable

On September 8, 2000, SMART entered into an installment purchase contract to acquire 100 transit coaches during fiscal year 2001 at a cost of \$27.3 million. The acquisition is financed at a 5.23% interest rate over a 10-year period, with a semi-annual payment of principal and interest of \$1.77 million, each due on February 15 and August 15 of each year. The contract also provides for two annual options to acquire 100 and 87 additional coaches during fiscal years 2002 and 2003, respectively, at interest rates indexed to the market. At June 30, 2003, all 100 buses were delivered.

In August 2001, SMART exercised its option to get 100 additional buses. This acquisition is financed at a 4.90% rate over a 10-year period, with semi-annual payment of principal and interest of \$1.9 million, each due on February 15 and August 15 of each year.

In October 2002, SMART exercised its option to acquire the final 87 buses. The acquisition is financed at a 4.70% rate over a 10-year period, with semi-annual payment of principal and interest of \$1.6 million, each due on February 15 and August 15 of each year. These three contracts are recorded as notes payable in the financial statements.

Subsequent to the acquisition of the first 100 transit coaches, the individual payment schedule (IPS#1), a significant downward fluctuation in the capital market interest rates occurred. The decrease in market rates was sufficient to warrant a restructuring of IPS#1 with a reduction in interest expense to SMART. Effective February 18, 2004, the new interest rate for IPS#1 is 4.44%, with a semi-annual payment of principal and interest of \$1.74 million. The restructuring of IPS#1 will reduce interest expense by over \$425,000 over the life of the note.

Note payable activity for the year ended June 30, 2005 was as follows:

Issue	Balance July 1, 2004	Additions	Deletions	Balance June 30, 2005	Due within one year
Note 1	\$ 19,424,056	—	2,646,607	16,777,449	2,756,967
Note 2	20,683,501	—	2,681,732	18,001,769	2,814,747
Note 3	<u>20,069,397</u>	—	<u>2,193,822</u>	<u>17,875,575</u>	<u>2,299,940</u>
Total	<u>\$ 60,176,954</u>	<u>—</u>	<u>7,522,161</u>	<u>52,654,793</u>	<u>7,871,654</u>

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Note payable activity for the year ended June 30, 2004 was as follows:

Issue	Balance July 1, 2003	Additions	Deletions	Balance June 30, 2004	Due within one year
Note 1	\$ 21,712,695	144,239	2,432,878	19,424,056	2,646,607
Note 2	23,238,506	—	2,555,005	20,683,501	2,681,732
Note 3	22,161,997	—	2,092,600	20,069,397	2,193,822
Total	\$ 67,113,198	144,239	7,080,483	60,176,954	7,522,161

As of June 30, 2005, the annual requirements to pay principal and interest on the notes are as follows:

	Principal	Interest	Total
Year ended June 30:			
2006	\$ 7,871,654	2,648,003	10,519,657
2007	8,246,285	2,273,372	10,519,657
2008	8,638,778	1,880,879	10,519,657
2009	9,049,988	1,469,670	10,519,658
2010 and thereafter	18,848,088	1,895,190	20,743,278
2011 and thereafter	—	—	—
Total	\$ 52,654,793	10,167,114	62,821,907

(10) Pensions

(a) Plan Description

SMART participates in the Municipal Employees' Retirement System (MERS) of Michigan. MERS is an agent multiple-employer, statewide public employee defined-benefit pension plan created under Public Act 135 of 1945, now operating under Public Act 220 of 1996. MERS was established to provide retirement, survivor, and disability benefits on a voluntary basis to the State of Michigan's local government employees.

Pursuant to Act 220, on August 15, 1996, MERS became an independent public nonprofit corporation, which is an instrumentality of the participating municipalities and courts. Prior to that, MERS was a component unit of the State of Michigan and operated within the Department of Management and Budget. MERS is administered solely by a Retirement Board. Benefit programs and provisions are established by the Retirement Board. MERS assigns the authority to establish and amend the benefit provisions of the plan to the respective employer entities. MERS of Michigan issues a publicly available financial report that includes financial statements and required supplementary information for MERS. That report may be obtained by writing to Municipal Employees' Retirement System of Michigan, 1134 Municipal Way, Lansing, Michigan, 48917 or by calling 1-800-767-6377.

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Substantially all SMART employees are members of the MERS plan. As of December 31, 2004, the date of the last actuarial valuation, 395 retirees and beneficiaries were receiving benefit payments, and the Plan had 993 active members and 152 inactive vested members.

Benefits vest after 6 years of service, with special provisions for death and disability. Normal retirement is at age 60 with 6 years of service or at age 55 with 15 years of service. Early retirement with reduced benefits is available beginning at age 50 with 25 years of service.

(b) Funding Policy

Members of only one of SMART's collective bargaining units make contributions to MERS. For the years ended June 30, 2005 and 2004, such employees contributed 3% of their payroll. SMART is required to contribute at an actuarially determined rate. For the fiscal year ended June 30, 2005, the rates, as a percentage of annual payroll, are as follows: ATU drivers, 12.35%; ATU clerical, 11.33%; UAW #771, 7.60%; Teamsters #247, 12.84%; AFSCME 1917, 14.78%; nonunion, 15.49%. The contribution requirements of plan members are established and may be amended by the Retirement Board of MERS.

(c) Annual Pension Cost

For fiscal years ended June 30, 2005 and 2004, SMART recorded annual pension expense of \$4,584,410 and \$4,370,713, respectively.

The required contribution amount was determined as part of the December 31, 2001 actuarial valuation using the entry-age normal cost actuarial method. The actuarial assumptions included: (a) 8% investment rate of return; (b) projected salary increase of 4.5% per year compounded annually, attributable to inflation; (c) additional projected salary increases of 0.0% to 4.2% per year, depending on age, attributable to seniority/merit; and (d) the assumption that benefits will increase 2.5% per year (annually) after retirement for pensions under certain categories. The actuarial values of assets are determined on the basis of a valuation method that assumes the fund earns the expected rate of return (8%) and includes an adjustment to reflect market value. SMART's unfunded actuarial accrued liability is being amortized as a level percent of payroll over a period of 30 years.

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SMART's annual pension cost and net pension obligations for the years ended June 30, 2005 and 2004 are as follows:

	<u>2005</u>	<u>2004</u>
Annual required contributions	\$ 4,583,112	4,354,884
Interest on net pension cost	3,938	48,023
Adjustment to annual required contribution	<u>(2,640)</u>	<u>(32,194)</u>
Annual pension cost	4,584,410	4,370,713
Contributions made	<u>5,035,859</u>	<u>4,921,769</u>
Decrease in net pension obligations	(451,449)	(551,056)
Net pension obligation at the beginning of the year	<u>49,229</u>	<u>600,285</u>
Net pension obligation (asset) at the end of the year	<u><u>\$ (402,220)</u></u>	<u><u>49,229</u></u>

- Three-year Historical Trend Information (dollar amounts in thousands):

	<u>Annual pension cost (APC)</u>	<u>Percentage of APC contributed</u>	<u>Net pension obligation/asset</u>
Fiscal year ended June 30:			
2003	\$ 4,528	120%	\$ 600
2004	4,371	113	49
2005	4,584	110	(402)

Required Supplementary Information (Unaudited)

- Analysis of Funding Progress (dollar amounts in thousands):

<u>Valuation date December 31</u>	<u>Actuarial value of assets (a)</u>	<u>Actuarial accrued liability (AAL) – entry age (b)</u>	<u>Unfunded AAL (UAAL) (b)-(a)</u>	<u>Funded ratio (a)/(b)</u>	<u>Annual covered payroll (c)</u>	<u>UAAL as a percentage of covered payroll (b)-(a)/(c)</u>
2002	\$ 95,739	115,645	19,906	82.79%	\$ 38,729	51%
2003	105,865	126,425	20,560	83.74	39,568	52
2004	135,308	113,930	(21,378)	118.76	40,335	N/A

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(11) Other Postretirement Benefits

In addition to the pension benefits described in note 10, SMART provides postretirement health insurance, life insurance, and prescription benefits to certain employees who retire after attaining age 60 with at least 6 years of service or after attaining age 55 with at least 15 years of service. For the years ended June 30, 2005 and 2004, approximately 275 and 221 retirees met those eligibility requirements. Expenses for health and life insurance are recognized monthly as premiums are paid. Expenses for prescriptions are recognized as retirees file claims. Expenses for such postretirement benefits for the years ended June 30, 2005 and 2004 were approximately \$1,362,791 and \$1,895,786, respectively.

(12) Commitments

SMART leases certain office space and equipment under operating lease agreements. Some leases include escalation clauses for SMART's pro-rata share of taxes and operating expenses. Most leases of office space and equipment are on a month-to-month basis. Total rent expense for the years ended June 30, 2005 and 2004 was approximately \$540,871 and \$506,793, respectively. SMART entered into a noncancelable lease commencing February 1, 2002 through January 31, 2005 for office space for its administrative office personnel and for a ticket sales store. The monthly rental payment on this lease is \$31,274. Future minimum lease payments are \$375,000 and \$375,000 for fiscal years ended June 30, 2005 and 2006, respectively.

(13) Contingencies

Various legal actions and workers' compensation claims are outstanding or may be instituted or asserted against SMART. Management has accrued amounts with respect to such actions and claims based on its best estimate of SMART's ultimate liability in these matters, including an estimate for claims that have been incurred but not reported for self-insured vehicle liability (see note 8).

(14) Deferred Compensation Plan

SMART offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan permits employees to defer a portion of their current salary until future years. The deferred compensation is not available to the employees until termination, retirement, death, or unforeseeable emergency.

All amounts of compensation deferred under the plan are held for the exclusive benefit of the participants and their beneficiaries and are not reflected in SMART's financial statements.